United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

77-7183, -7186

United States Court of Appeals

FOR THE SECOND CIRCUIT

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P/S

EDWARD S. REDINGTON, as Trustee for the liquidation of the business of Weis Securities, Inc., and SECURITIES INVESTOR PROTECTION CORPORATION,

Plaintiffs-Appellants,

—against—

TOUCHE ROSS & CO.,

Defendant-Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

TRUSTEE'S BRIEF ON APPEAL

HUGHES HUBBARD & REED
Attorneys for Plaintiff-Appellant Edward S. Redington, as Trustee for the liquidation of the business of Weis Securities, Inc.
One Wall Street
New York, New York 10005
(212) WH 3-6500

Of Counsel:

JOHN S. ALLEE
JAMES B. KOBAK, JR.
JOHN W. SCHWARTZ
HAROLD L. KAPLAN

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United States Court of Appeals

FOR THE SECOND CIRCUIT

Docket Nos. 77-7183 and 77-7186

EDWARD S. REDINGTON, as Trustee for the liquidation of the business of Weis Securities, Inc., and SECURITIES INVESTOR PROTECTION CORPORATION,

Plaintiffs-Appellants,

—against—

TOUCHE ROSS & Co.,

Defendant-Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

TRUSTEE'S BRIEF ON APPEAL

Preliminary Statement

This brief is submitted by Edward S. Redington, Esq., plaintiff-appellant in Docket No. 77-7183, in support of his appeal from an order of the Honorable Inzer B. Wyatt, United States District Judge, dismissing this action and each claim for relief pleaded by plaintiff Redington for lack of subject matter jurisdiction. Judge Wyatt's opinion is reported at 428 F. Supp. 483 (S.D.N.Y. 1977) and is reproduced at pages 391a to 414a of the Joint Appendix.

Plaintiff Redington is the Trustee appointed by order of the District Court to liquidate the business of Weis

Securities, Inc. ("Weis") pursuant to the Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa *et seq.* ("SIPA"). He is sometimes referred to in this brief as the "Trustee."

A separate brief is being submitted on behalf of the Trustee's co-plaintiff below, the Securities Investor Protection Corporation ("SIPC"), appellant in Docket No. 77-7186. Those portions of SIPC's brief dealing with issues common to both appellants—i.e., the reasons for implying a private right of action under Section 17 of the Securities Exchange Act of 1934[1]—are incorporated herein by reference. This brief addresses only the jurisdictional issues which relate particularly to the Trustee's claims for relief.

This case involves the liability of a firm of certified public accountants which audited Weis and certified the adequacy of its financial statements under Section 17 of the Exchange Act and the rules and regulations thereunder; the audit failed to detect false and fraudulent entries in Weis' books and records, substantial overstatements of Weis' profitability and net worth and serious misstatements of its net capital ratio. The audit is alleged to have been at least negligent, if not grossly negligent and reckless, and to have been the proximate cause of a SIPA liquidation in which the Trustee has not been able to make all of Weis' customers and creditors whole.

Federal question jurisdiction over the Trustee's action is based on Section 17 of the Exchange Act and principles of pendent jurisdiction; independent jurisdictional grounds for the Trustee's non-Section 17 claims are based on the

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[1] 15 U.S.C. §§ 78a *et seq.* (hereinafter the "Exchange Act"). References to the Exchange Act are to that Act as it existed in 1973. The Act underwent immaterial amendments in 1975. Pub. L. No. 94-29, 89 Stat. 97 (June 4, 1975).

bankruptcy, Chapter X and federal equity receivership jurisdiction conferred on the District Court by Sections 5 and 6 of SIPA.

Statutes and Rules Involved

Section 17 of the Exchange Act, 15 U.S.C. § 78q, and SEC Rule 17a-5, 17 C.F.R. § 240.17a-5 ("Rule 17a-5") as they existed in 1972 are set forth in relevant part in an Addendum to this brief. Sections 5(b)(2), 6(b)(1) and 6(c)(1) of SIPA, 15 U.S.C. §§ 78eee(b)(2), fff(b)(1) and fff(c)(1), and Sections 2a(7), 23, 102 and 115 of the Bankruptcy Act, 11 U.S.C. §§ 11a(7), 46, 502 and 515, are also included in relevant part in the Addendum.

Issues Presented for Review

1. Whether a SIPA Trustee has standing to sue a firm of certified public accountants under Section 17 of the Exchange Act for losses proximately caused by a deficient Rule 17a-5 audit a) to the funds of customer property held by the Debtor as bailee for its customers and b) to the Debtor itself, when recovery will ultimately benefit all customers and creditors?

2. Whether the District Court had jurisdiction as a Court of Bankruptcy over the Trustee's claims for relief a) by virtue of jurisdictional provisions in SIPA giving district courts the full bankruptcy jurisdiction of Chapter X courts; b) by virtue of Section 115 of Chapter X (incorporated in Section 6(c)(1) of SIPA) giving district courts at least the jurisdiction of a federal equity receivership court; or c) by virtue of the "consent of the defendant" (as manifested in the filing of two proofs of claim) under Section 23 of the Bankruptcy Act?

Statement of the Case

The Factual Background and Requirements of Rule 17a-5

The liquidation of Weis was commenced by order of the Honorable Murray I. Gurfein, then a District Judge, on May 30, 1973. Prior to its forced liquidation, Weis had been a broker-dealer in securities and a member of the New York Stock Exchange, Inc. (the "Exchange"). (7a.) Weis was subject to regulation under the Exchange Act by the Securities and Exchange Commission (the "SEC") and by the Exchange in its capacity as a self-regulatory organization. Sections 6 and 19 of the Exchange Act, 15 U.S.C. §§ 78f, 78s.

Among the regulations to which Weis was subject were the "net capital" and related financial responsibility rules promulgated by the SEC and the Exchange. At the times here relevant, Section 17 and the rules and regulations thereunder required an audited year-end financial statement called the "Answers to the Financial Questionnaire" to be filed with the Exchange and the SEC. (7a, 11a.) Paragraphs (g) through (*i*) of Rule 17a-5 required the accountant to make specific representations and certifications about the scope of its audit and the nature of its opinion with respect to that document, especially as they related to a broker's compliance with rules adopted for the protection of customers.

Thus, an accountant was required by Rule 17a-5(g)(2) to identify in his certificate the items of the report covered by the certificate and was required to give a "reasonably comprehensive statement as to the scope of the audit made, including a statement whether the accountant reviewed the procedures followed for safeguarding the securities of customers * * *." The Rule also required the accountant

to state "whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances; and * * * whether the audit made omitted any procedure deemed necessary by the accountant under the circumstances of the particular case." Subparagraph (g)(3) concluded with the warning: "Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required by paragraph (h) of this section."

Paragraph (h) required that the accountant not only certify that he had performed all necessary auditing procedures, but that his certification "state clearly" the accountant's opinion "with respect to the financial statement covered by the certificate and the accounting principles and practices reflected therein." And finally, paragraph (*i*) required the accountant to flag potential trouble spots by providing: "Any matters to which the accountant takes exception shall be clearly identified; the exception thereto shall be specifically and clearly stated; and to the extent practicable, the effect of each such exception on the related item of the report shall be given."

The regulations relating to audited financial statements and accountants' certificates were part of an extensive system of regulation of broker-dealers designed to ensure their financial stability. (For a detailed discussion of this system see SIPC's Brief.) The regulations were designed to ensure the integrity of broker-dealers' financial reports so that regulatory authorities, customers, other interested members of the public and the officers and directors of the brokerage firm itself could determine whether a firm was adequately capitalized both in terms of the special rules (such as the net capital rules) required by regulatory

authorities for the protection of customers and customer property and in terms of more general concepts of solvency and profitability.

Touche Ross' Role in the Weis Debacle

From 1969 to the date of its forced liquidation Weis engaged Touche Ross as its accountant and auditor for various purposes, including especially the preparation, audit and certification of reports complying with the requirements of Rule 17a-5 as well as with generally accepted accounting principles and generally accepted auditing standards. (10a.) Among the series of audits and other accounting services which Touche Ross undertook to perform were those preceding certification of Weis' Answers to Financial Questionnaire and other documents for Weis' fiscal year ended "as at May 26, 1972." (11a-13a.)

After performing some services in May, June and July of 1972, Touche Ross signed opinion letters with respect to four different financial documents, including the Answers to Financial Questionnaire required to be audited and certified by Rule 17a-5. (13a-14a, 34a, 41a, 62a, 75a.) Each of these opinion letters was addressed to the Weis board of directors. In each letter Touche Ross represented that it had examined the financial statement "in accordance with generally accepted auditing standards," and in each Touche Ross opined that the financial statement presented "fairly the financial position" of Weis as at May 26, 1972. In the case of income statements (62a, 75a) Touche Ross also opined that the statement presented fairly the results of operations over the preceding 52 weeks and the preceding five years.

As might be expected given the special responsibilities imposed on auditors by paragraphs (g) through (*i*) of Rule 17a-5, the opinion letters signed by Touche Ross with respect to the Answers to Financial Questionnaire, though

containing representations of the type described above, also contained additional representations. Thus Touche Ross stated that it had "included a review of the accounting system, internal accounting control and the procedures for safeguarding securities * * * including the audit procedures prescribed by the New York Stock Exchange and the Securities and Exchange Commission." (41a.) Touche Ross also represented that it had audited the Weis net capital computation as at May 26, 1972 and opined that "such information is fairly presented in all material respects in relation to the answers of the financial questionnaire taken as a whole * * *." (52a.)

Finally, Touche Ross signed a "Report on Internal Control" regarding its review of Weis' system of internal accounting control. (59a.) This review was undertaken "to establish a basis for reliance thereon" in determining what auditing procedures should be applied. According to Touche Ross, its "study and evaluation disclosed no conditions that we believe to be material weaknesses." (*Id.*)

The Touche Ross audit, in other words, gave the Weis financial statements and internal accounting systems a clean bill of health. The Touche Ross opinions did not contain a single qualification or exception. The absence of any negative comments was one of the most significant things about these opinions. Under Rule 17a-5 Touche Ross was required not only to "state clearly [its] opinion" with respect to the Answers to Financial Questionnaire "and the accounting principles and practices reflected therein" (Rule 17a-5(h)), but also to state "specifically and clearly" any "exception" it had to "[a]ny matters" otherwise covered by its opinion (Rule 17a-5(*i*)). Touche Ross was also required to state "whether the audit made omitted any procedure deemed necessary by the accountant under the circumstances of the particular case." (Rule 17a-5(g)(2)(iii).)

Inadequacy of the Touche Ross Audit

Despite the representations in the Touche Ross opinions, the reports audited and certified by Touche Ross "as at May 26, 1972" proved in fact to be materially false and misleading in many respects. The income statements reflected an ostensible pre-tax profit of $1,700,000 when Weis had in fact lost at least $1,500,000; all of the reports misstated Weis' net worth and net capital position by substantial amounts. (7a-8a, 15a-20a.)

At the time of Touche Ross' audit, the books and records of Weis contained many entries that had been falsified by a small cadre of Weis officers and employees. (7a-8a, 15a-18a.) These false entries, undetected by Touche Ross despite the unqualified representations about the scope of its audit, infected not only the statements dated "as at May 26, 1972" but every report or statement thereafter filed with the Exchange and the SEC, distributed to customers and shown to Weis' board of directors. The system of internal accounting controls given a clean bill of health by the Touche Ross audit had in fact been easily manipulated by the miscreant Weis officers and employees in preparation for the audit as at May 26, 1972; once given the *imprimatur* of Touche Ross, that system continued to be manipulated to disguise Weis' deteriorating financial position and net capital problems throughout the rest of 1972 and early 1973. (8a-9a.)

The Complaint alleges that had Touche Ross conducted a competent audit and examination of Weis' system of internal control, and had it performed all the services that it represented that it had performed in its certificates and opinions with respect to the Answers to Financial Questionnaire and its other opinion letters (*see* 13a-15a, 34a, 41a, 52a, 59a, 62a, 75a), it could not have failed to have discovered these misstatements (15a-20a) at a time when the

falsification of books and records could have been nipped in the bud and prompt remedial action might still have saved Weis and ensured that adequate assets were being held for customers. (8a-9a.) Because of Touche Ross' defective audit, Weis' true financial condition was unknown and its forced liquidation in May 1973 could not be avoided.

Touche Ross' Claims for Continued Accounting Services

The audit in question was dated as at May 26, 1972 but was actually completed in early July. Thereafter Touche Ross continued to perform auditing and accounting services for Weis, the most substantial of which were the steps taken to begin its next audit in 1973. Touche Ross has submitted a claim in the Weis liquidation for over $75,000 with respect to these ongoing services. (293a-294a.) Over $67,000 of this amount is asserted for services in connection with the next in the series of Touche Ross audits, that begun in April 1973 and based in large part on the results of the previous defective audit certified in July 1972. (294a.)

This last in the series of audits was never completed because Weis was liquidated almost a year to the day after the date the audit as at May 26, 1972 began. This forced liquidation was triggered by investigations of Weis' books and records conducted in late April and May of 1973 by the SEC and the Exchange; that investigation revealed substantial inaccuracies in the figures that had been reported to Weis' directors, to the Exchange and to Weis' customers. (9a.) Defendant Touche Ross participated in that investigation and has even submitted a claim in the Weis liquidation for over $11,000 for its services "for benefit of estate" at that time. (295a-96a.) The records that were found to have been false as a result of these investigations, and for the discovery of which Touche Ross

has billed the estate, included those for which the Complaint alleges Touche Ross was responsible.

The Complaint

This action involves six claims for relief by the Trustee and eight claims for relief by plaintiff SIPC. Essentially, both plaintiffs allege that Touche Ross was negligent and breached specific duties to each plaintiff which it voluntarily assumed under Section 17 of the Exchange Act and under various principles of common law. Touche Ross assumed these duties when it accepted the engagement to be Weis' auditor and undertook to perform all necessary auditing and accounting services required to audit Weis' Answers to Financial Questionnaire and related documents. The Complaint alleges not only that Touche Ross breached these duties, but also that it falsely certified that it had performed all appropriate services and made false representations with respect to the Answers to Financial Questionnaire and other documents dated as at May 26, 1972.

These factual allegations appear as common allegations and comprise 24 paragraphs of the Complaint. They include detailed statements of some of the areas where Touche Ross' services were materially deficient. (*See* 15a-18a.)

Plaintiff SIPC claims in a separate section of the Complaint (¶¶ 50-85, pp. 23a-31a) that these false certifications and acts of misfeasance by Touche Ross breached duties of care owed to SIPC directly, as a party on whose behalf regulatory reports were required to be filed, and indirectly, on behalf of customers whose claims it has been forced to satisfy because of the insufficiency of customer property available in the liquidation of Weis.

In his section of the Complaint (¶¶ 32-49, pp. 20a-23a) the Trustee claims that these false certifications and acts of

misfeasance by Touche Ross also breached duties owed separately to Weis as the party which contracted for auditing and accounting services, as well as to customers who were the intended beneficiaries of the financial responsibility rules and the related auditing and certification requirements. The Trustee's section of the Complaint specifically alleges that Touche Ross' deficient auditing services prevented Weis from preserving and safeguarding property which it held or should have held in trust for its customers. (19a.)

The Trustee's Six Claims

The Trustee's six separate causes of action against Touche Ross involve one claim for relief under the Exchange Act (Complaint ¶¶ 32-35, pp. 20a-21a), over which the District Court had federal question jurisdiction pursuant to Section 17 of the Exchange Act and 28 U.S.C. § 1331, and five claims for relief under the laws of New York. (¶¶ 36-49, pp. 21a-23a.) These state law claims arise from the same facts as the Trustee's and SIPC's Section 17 claims, and thus the Court had pendent jurisdiction over them. There is also an independent jurisdictional basis for the Trustee's non-Section 17 claims under SIPA and various provisions of the Bankruptcy Act made applicable by SIPA. (Complaint ¶ 2, p. 5a; see pages 27-42, *infra*.)

Opinion Below

After plaintiffs had initiated some discovery defendant moved to dismiss the Complaint on jurisdictional grounds and to dismiss all SIPC's claims and certain of the Trustee's claims (those for breach of contract, breach of warranty and negligence *per se* in failing to perform duties referred to under Rule 17a-5) for failure to state a claim upon which relief could be granted under New York law. Defendant also moved, in the alternative, to stay

this action in favor of a similar, but necessarily less inclusive, State Court action[2] instituted by the Trustee and SIPC as a precautionary matter to guard against any possible running of the statute of limitations.

Since the District Court ruled in defendant's favor on jurisdictional grounds, it did not reach the other questions raised in Touche Ross' omnibus motion. It should be noted, however, that the gist of defendant's position is that an accountant can only be sued for negligence by those in privity of contract with it and can never be sued directly *by anyone* for failing to perform the services it agrees explicitly or implicitly to perform for the benefit of customers when it undertakes a Rule 17a-5 audit and makes the required certifications.

The District Court granted the motion to dismiss with respect to the Section 17 claims on the theory that "Section 17 was designed to supply administrative guidance in the bookkeeping area and not to create any rights in anybody" against accountants. (428 F.Supp. at 489.) Despite SIPC's obligations to pay customer claims and Weis' duties to hold funds of customer property reasonably adequate to satisfy customer claims, the court also stated that neither plaintiff was an "investor" who could have standing to sue under Section 17. (428 F.Supp. at 491.)

The District Court also dismissed for lack of jurisdiction the Trustee's common law claims. The Court held that bankruptcy court jurisdiction did not exist because "Section 46 of Title 11 [Section 23 of the Bankruptcy Act] is applicable to SIPA liquidations" (428 F.Supp. at 492)

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[2] Redington and SIPC v. Touche Ross & Co., Index No. 13996/76 (Supreme Court, New York County). The State Court action does not involve Section 17 claims because federal court jurisdiction over those claims is exclusive.

under Section 6(c)(1) of SIPA despite the more specific jurisdictional provisions in SIPA and the broader base of jurisdiction made available by Section 115 of the Bankruptcy Act even if Section 6(c)(1) is considered a jurisdictional provision. The court noted without explanation that the arguments for the Trustee concerning these provisions "have been considered but cannot be accepted." (428 F.Supp. at 492.)

One issue the court did discuss, if briefly, was Touche Ross' consent to bankruptcy jurisdiction under Section 23 of the Bankruptcy Act by filing its proofs of claim for continued accounting services after signing the certificates in July of 1972. The District Court held that Touche Ross' consent did not extend to claims based on the audit "as at May 26, 1972" because "the claim filed by Touche in the Weis liquidation was for accounting work in *European offices of Weis* in late 1972 and early 1973, as well as for a Stock Exchange audit as of April 27, 1973." (428 F.Supp. at 492; emphasis in original.) In fact, the bulk of the Touche Ross general creditor claim (293a-94a) was for work in connection with the 1973 audit—the last of the same series of audits as that worked on the year before and one that necessarily involved the same figures certified by Touche Ross in 1972.

Moreover, Touche Ross submitted a second, apparent priority claim of which no mention is made in the opinion below. In that document Touche Ross claimed to have performed some $11,000 of services "for benefit of estate." (295a-96a.) This $11,000 includes more than $7,500 attributable to meetings with the SEC and the Exchange and "[s]ubstantiation and documentation of alleged fraudulent bookkeeping practices and entries." (296a.) These are the very practices and entries for which the Complaint alleges that Touche Ross was responsible.

ARGUMENT

I.

The Trustee Has a Private Right of Action Against Weis' Accountants Under Section 17 of the Exchange Act.

A. *Customers Should Have Standing to Sue Under Section 17 for Losses Sustained as a Result of an Accountant's Non-Compliance With Rule 17a-5.*

Defendant's position below that Section 17 and Rule 17a-5 impose no duties on an accounting firm to anyone plainly overshoots the mark. The audited Answers to Financial Questionnaire and the unqualified certifications and representations made by Touche Ross with respect to it were specifically required by paragraphs (g) through (*i*) of Rule 17a-5. Those paragraphs were promulgated under Section 17(a) of the Exchange Act "in the public interest" and "for the protection of investors." The Rule 17a-5 requirement that a brokerage firm have appropriately audited financial statements has always served as the keystone for the "early warning system" and indeed the entire scheme by which the financial condition of brokers and dealers is regulated for the protection of investors. *See Boruski* v. *SEC*, 340 F.2d 991 (2d Cir. 1965); Report and Recommendations of the Securities and Exchange Commission, Study of Unsafe and Unsound Practices of Brokers and Dealers, H.R. Doc. No. 92-231, 92d Cong., 2d Sess., 24-27, 31 (1971).

For the reasons stated in SIPC's Brief, it is clear that a private right of action exists under Section 17 at least for customers and those who represent their interests—the class "for whose *especial* benefit the statute was enacted."

Cort v. *Ash*, 422 U.S. 66, 78 (1975), *quoting Texas & Pacific Ry.* v. *Rigsby*, 241 U.S. 33, 39 (1916). The policies are the same as those which long ago caused this Court to imply a right of action for customers against securities exchanges under Section 6 of the Exchange Act. *Baird* v. *Franklin*, 141 F.2d 238 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944). *See Lank* v. *New York Stock Exchange*, 548 F.2d 61, 64-66 (2d Cir. 1977); *Arneil* v. *Ramsey*, 550 F.2d 774, 783 (2d Cir. 1977). As this Court explained in *Lank*, "[t]he primary purpose of the Exchange Act was to protect customers of the stock exchanges—that is, public investors. * * * The beneficiary of the 1934 legislation was intended to be the public investor." 548 F.2d at 64, 65.

The logic that permits customers to sue a stock exchange for failure to enforce its rules should permit customers to sue an accountant for failing to live up to its certifications under Rule 17a-5. Section 17 is an integral part of the same scheme of broker-dealer regulation as Section 6. Section 17 and Rule 17a-5, like Section 6 and the rules and regulations thereunder, were promulgated "in the public interest" and "for the protection of investors." When the SEC amended the rule in 1957 it explained that the amendment was to:

> "[a]dd another important protective feature to the Commission's continuing program for improving the safeguards afforded to customers of broker-dealer firms * * *. *The Commission believes that it is essential, for the protection of public investors, that the accounts of these broker-dealers who do business with the investing public and handle customer funds and securities be subject to an annual audit by an independent accountant.*" (Emphasis added.)

SEC News Digest (Aug. 8, 1957) at 3. This Court, in discussing the requirement of audited financials in *Boruski* v. *SEC*, *supra* stated:

> "The regulations are not shown to be unreasonable; indeed, it is difficult to see how the Commission could carry on its task of protection of the public investor without financial information such as it sought here." (*Boruski* v. *SEC*, *supra*, 340 F.2d at 992.)

Accountants are or should be aware of their role in the regulatory scheme and of the implicit reliance placed upon their work by the investing public when they undertake to conduct Rule 17a-5 audits. It is not unreasonable to hold accountants liable under Section 17 to the extent that customers are injured by accountants' failures to comply with the SEC rules promulgated under Section 17.

B. *A SIPA Trustee Should Have Standing to Sue for Loss or Damage to Customer Property as a Result of an Accountant's Non-Compliance With Rule 17a-5.*

The District Court, alluding to this Court's decision in *Lank* v. *New York Stock Exchange*, *supra*, held that the Trustee lacked standing to maintain a Section 17 action because Weis was not itself a customer of Weis. (428 F. Supp. at 491.) There are many reasons why the result reached in *Lank* is inapplicable to a Section 17 action against an accountant (see pages 23-26, *infra*), but perhaps the clearest is based on the SIPA Trustee's responsibilities to marshal and return customers' property to a broker-dealer's customers.[3] The Trustee should be able to stand

[3] *Lank* involved a Delaware receiver, not a SIPA trustee. Customer accounts had been transferred to other brokers. The broker's stewardship of customers' property thus was not involved in the decision; the receiver did not assert any claims as bailee for customers.

in the customers' shoes for purposes of recovering for harm or diminution to property which was held by Weis not for its own account but as trustee or bailee for its customers.

The law is clear that a bailee, being entitled to the possession of the property bailed, has a special interest in it which is sufficient to entitle him to sue third parties for a loss of, or injury to, the property:

> "For centuries it has been the settled rule both at common law and in admiralty, that either the bailor * * * or the bailee * * * might sue the tortfeasor for destruction of the bailed goods." *The W. C. Block*, 71 F.2d 682, 683 (2d Cir.), *cert. denied*, 293 U.S. 579 (1934). (Citations omitted.)

Accord, e.g., The Beaconsfield, 158 U.S. 303, 307 (1895); *Luckenbach Steamship Co.* v. *United States*, 315 F.2d 598, 605 (2d Cir. 1963); *Bradley* v. *St. Louis Terminal Warehouse Co.*, 189 F.2d 818, 823 (8th Cir. 1951); *Rogers* v. *Atlantic, Gulf & Pacific Co.*, 213 N.Y. 246, 258, 107 N.E. 661, 664 (1915). As the Sixth Circuit explained in *Baldwin* v. *Hill*, 315 F.2d 738, 742 (6th Cir. 1963):

> "While it is true that a bailee does not have title to the bailed chattels, still he has a possessory interest in them. He may recover damages for injury done to the property and has other possessory rights. *With respect to third persons, he stands in the place of the owner.*" (Emphasis added.)

The relationship of Weis (and its SIPA Trustee) to cash customers' specifically identifiable property and property in the single and separate fund of customer property was a bailment relationship. *Rich* v. *Touche Ross & Co.*, 415 F. Supp. 95, 99 (S.D.N.Y. 1976); see pages 19-20, *infra*.

The Trustee "stands in the place" of Weis' customer-bailors for purposes of bringing an action against Touche Ross for acts or omissions which proximately caused loss to the funds of customer property that Weis should have been holding on the filing date.

A bailment involves the possession or retention by one person, for some particular purpose, of personal property owned by another person upon a contract, express or implied, that after the purpose has been fulfilled it shall be returned to the owner or otherwise dealt with according to the directions of the owner. *Rich* v. *Touche Ross & Co., supra,* 415 F.Supp. at 99 n.2; *Mays* v. *New York, N.H. & H. R.R.*, 197 Misc. 1062, 1063-64, 97 N.Y.S.2d 909, 911 (1st Dep't 1950). The relationship of broker to customer has always been regarded as essentially one of bailment. Judge Brieant in the *Rich* case, *supra,* has even held that the relationship of *this* broker to its customers was one of bailment.

Even prior to SIPA or Section 60e of the Bankruptcy Act, when concepts of ownership originally developed for tangible property were somewhat rigidly applied to intangibles, customers of stockbrokers were considered the owners of stock held in the broker's own name under the majority or "New York" rule. In fact, even in margin transactions, where the metaphysics of title seemed least clear, the customer was considered owner of the stock and the broker was considered but a pledgee—a classic type of bailment relationship.[4] *E.g. Gorman* v. *Littlefield,* 229

[4] Even under the minority or "Massachusetts" rule, the bankruptcy of the broker was deemed to vest title to the stock held by the broker in the customer, who could then obtain possession by paying any debit balance owing. In practice, therefore, the results were substantially the same as under the New York rule. *Leonard* v. *Hunt*, 36 F.2d 13, 15 (1st Cir. 1929). 3 W. Collier, *Bankruptcy* ¶ 60.72 at 1159-60 (14th ed. 1976); Note, *Protection of the Accounts of Stockbrokerage Customers*, 77 Harv. L. Rev. 1290, 1299 (1964).

U.S. 19 (1913); *Sexton* v. *Kessler & Co.*, 225 U.S. 90 (1912); *Richardson* v. *Shaw*, 209 U.S. 365 (1908); *Content* v. *Banner*, 184 N.Y. 121, 76 N.E. 913 (1906); *Markham* v. *Jaudon*, 41 N.Y. 235, 241 (1869). The New York rule has been codified in Section 8-313(2) of the Uniform Commercial Code:

> "(2) The purchaser is the owner of a security held for him by his broker * * *. Where a security is part of a fungible bulk the purchaser is the owner of a proportionate property interest in the fungible bulk."

The same basic concept—that customers remain the owners of shares of stock registered in the broker's name for convenience or of cash commingled with the broker's own property—underlies the scheme of remedies provided for customers by Congress first in Section 60e of the Bankruptcy Act and ultimately in SIPA. In order to minimize the inequitable results to particular customers sometimes reached because of the technicalities of the New York rule, Section 60e and SIPA recognize the rights of customers as a group to the aggregate of customer property even when a specific customer cannot trace to a particular stock, as was required under the New York rule. *See* Bankruptcy Act § 60(e)(2), 11 U.S.C. § 96(e)(2); SIPA Sections 6(c)(2)(B) and 6(c)(2)(C), 15 U.S.C. §§ 78fff(c)(2)(B), (c)(2)(C); 3 W. Collier, *Bankruptcy* ¶ 60.71 at 1158 (14th ed. 1976); H.R. Rep. No. 1409 on H.R. 8046, 75th Cong. 1st Sess. 31 (1937).

Under SIPA the New York rule in essentially its common law form is applied to "specifically identifiable property" of "cash customers"—fully paid for securities in customer name or fully paid for securities in street name "allocated" to cash customers—but extended to recognize modern bulk segregation practices in accordance with SEC

requirements. SIPA Section 6(c)(2)(C), 15 U.S.C. § 78fff (c)(2)(C). All other property "at any time received, acquired or held * * * from or for the account of customers," including securities equal to 140 percent of a margin customer's margin indebtedness to the broker, and properly commingled by the broker with its own property, is conceived of as part of a "single and separate fund" of "customer property." SIPA Section 6(c)(2)(B), 15 U.S.C. § 78fff(c)(2)(B). This property cannot be identified to any particular customer and cannot necessarily be returned in kind but is nevertheless recognized as property owned by customers collectively rather than as simply having become a part of the broker's general assets.

All of these provisions are based on a recognition that customers never lose ownership of customer property, no matter how it may be registered, hypothecated or commingled in the broker's hands, and that the broker owes a special bailee's duty to safeguard that property (at least in the aggregate) and remain able to return it. While the broker is a functioning concern, its stewardship of large amounts of customer property subjects it to strict rules regarding hypothecation and segregation of securities and cash (SEC Rules 15c2-1, 15c3-3, 17 C.F.R. § 240.15c2-1, c3-3), and unique net capital rules designed to ensure that it will be reasonably able to meet its special obligations as custodian of customer property (SEC Rule 15c3-1, 17 C.F.R. § 240.15c3-1). *See* Guttman, *Broker-Dealer Bankruptcies,* 48 N.Y.U.L. Rev. 887, 893-903 (1973).

When the broker is liquidated under SIPA the Trustee is under a duty to marshal both specifically identifiable property and the single and separate fund and return this customer property to customers "as promptly as possible." SIPA Section 6(a)(1), 15 U.S.C. § 78fff(a)(1). That is the primary purpose of a SIPA liquidation. Surely the Trus-

tee stands in the shoes of the broker's customers for purposes of recovering for damage to, or diminution of, these funds just as the broker itself can—and commonly does—stand in customers' shoes in recovering stolen or converted securities or enforcing trades with other brokers for customers' accounts.

Damage to the customer property held by Weis as bailee is clearly alleged in the Complaint. Thus, paragraph 12 of the Complaint (8a-9a) alleges that because of Touche Ross' false certifications of the reliability of Weis' records:

> "[t]he doctoring of Weis' books, records and required reports, the deterioration of its financial condition and the violations of financial responsibility rules could not be nipped in the bud at a time when a forced liquidation of Weis could still have been avoided. Instead, during Weis' fiscal year 1973, Weis' financial condition deteriorated further as the Weis policy of expansion continued unabated. Weis incurred substantial operating losses, depletion of its assets, and *depletion of the property held by Weis in trust for its customers.*" (Emphasis added.)

Because of Touche Ross' false certifications, neither Weis' customers nor the regulatory authorities and officers and directors of the brokerage house who could have taken corrective action were given the early warning which is intended by a Rule 17a-5 report. The result was erosion and depletion of property held by Weis, both its own property and the customer property which it held as bailee.

For example, the Complaint alleges that certain error account amounts which might otherwise have been included in the fund of specifically identifiable property and thus have been returnable in full to eligible cash customers

were not available because of their entry, undetected by Touche Ross, as false credit balances, which were then erroneously taken into Weis' income. (17a.) Similarly, the failure of the Touche Ross audit to provide early warning of violations of financial responsibility rules allowed Weis to violate the net capital rules and to continue commingling customer property with its own property. This property was dissipated as Weis was permitted to continue ruinous business practices because its prior losses had not been detected by Touche Ross. (18a-20a.)

Because of Touche Ross' deficient audit, moreover, Weis' true financial condition was concealed until its forced liquidation could not be avoided. Thus, customer property could not be safeguarded as completely as would have been the case had the true facts been known earlier and Weis been merged with another broker or saved as a going concern.[5]

The Trustee has been able to marshal and return to customers only 67% of the property which should have constituted the single and separate fund of customer property. (*See* 19a.) He should be able to state a claim under Section 17 against Touche Ross to the extent that Touche Ross' deficient audit caused Weis to lose, dissipate or convert nearly one-third of the property it was supposed to have been holding for its customers. The Complaint here alleges this type of harm to customer property, and it should have been sustained against a motion to dismiss.

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[5] In a forced liquidation some losses are inevitably sustained on customer property because of such things as legal and administrative costs incurred as banks exercise their rights with respect to the millions of dollars of customer securities hypothecated with them.

C. *A SIPA Trustee Should Have Standing to Sue for Other Losses Sustained by a Broker as the Result of an Accountant's Non-Compliance With Rule 17a-5.*

The Trustee argued below that the same reasons that have led courts in other circuits to imply a right of action against a securities exchange for the representative of a defunct broker under Section 6 apply with even greater force to a suit by a trustee under Section 17 against a broker's accountant. *See, e.g., Collins* v. *PBW Stock Exchange, Inc.*, 408 F. Supp. 1344 (E.D. Pa. 1976). *See also Buttrey* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969). The relevant considerations were well stated by Judge Lasker in *Lank* v. *New York Stock Exchange*, 405 F. Supp. 1031 (S.D.N.Y. 1975), a case subsequently reversed by this Court (548 F.2d 61 (2d Cir. 1977)) on grounds irrelevant to a suit against an accountant:

> "The same reasoning [that allows customers to have a right of action] supports an action by a corporation, at least where, as here, the action is asserted by a receiver in liquidation. A corporation * * * is required by its status to rely on those responsible for the management of the firm to comply with the net capital rule and is therefore entitled to the Exchange's diligent enforcement. A brokerage corporation as an entity is more than its officers and directors. It is also capable of sustaining damages as a result of violations of the securities laws and regulations and the rules of the Exchange by those charged with its day to day control. In such circumstances a corporation is entitled to the benefits and protection of § 6 and has standing to sue accordingly." (405 F. Supp. at 1037.)

The same considerations even more clearly support a private right of action in favor of the Trustee for the liquidation of the firm with which Touche Ross contracted to perform the auditing and accounting services required by Rule 17a-5. Weis, like any brokerage corporation, was "more than its officers and directors." It was entitled to "diligent" audits under Rule 17a-5 to at least the same extent that it was entitled to "diligent enforcement" by the Exchange. Weis contracted with Touche Ross and paid it substantial sums over the course of five years to perform the auditing and accounting services required by Rule 17a-5.[6]

The rationale for this Court's decision reversing Judge Lasker in *Lank* is not applicable to a suit against an accounting firm under Section 17. The *Lank* rationale was stated by Judge Medina as follows:

> "The cases relied upon by Judge Lasker in extending exchange liability to member organizations all sought to effectuate the purpose of Section 6. But that purpose was to protect public investors. Their interests may often be antagonistic to those of exchange members, and it could well have a serious disruptive effect on the securities industry and the national economy itself were we to require an exchange so to enforce its rules as to avoid possible risk to its own members and their creditors and stockholders in such a way that the interests of public investors, paramount in the legislative scheme, are disregarded." (*Lank* v. *New York Stock Exchange, supra,* 548 F.2d at 66.)

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[6] The full amount of these payments is not known by the Trustee, but Touche Ross asserts that the Trustee owes it more than $67,000 for the preliminary steps undertaken in connection with the uncompleted audit commenced on April 27, 1973. (*See* 293a-94a).

This same concern was expressed again in *Arneil* v. *Ramsey*, 550 F.2d 774 (2d Cir. 1977):

> "As we observed in *Lank*, the interests of the public customer may often be in conflict with those of member firms, and solicitude for the interests of the member firms in order to avoid possible liability later may well redound to the detriment of the public investors. Paramount in the scheme of federal securities legislation is protection of the public investor." (*Id.* at 783.)

The fear voiced in *Lank* and *Arneil* was that exposing an exchange to potential liability to members for not enforcing rigorous rules would only encourage the exchange to adopt lax regulations and handle problems "within the club." The exchange might become more concerned with protecting itself from suit than with protecting the public investor.

These considerations do not apply to suits against accountants under Rule 17a-5. The accountant does not make policy judgments; his duty is simply to verify the state of affairs so that others may act. Implying a right of action in a trustee will only increase the incentives for the accountant properly to perform the duties it contracts to perform; the accountant will be encouraged to provide the earliest possible warning of potential problems to a firm's management and to regulatory authorities. The protection of everyone who deals with a broker, including customers, would be enhanced by such a rule.

The allegations of the Complaint in this case well illustrate the need for implying such a right of action. The last clear chance to avoid the Weis *debacle* was squandered when Touche Ross falsely represented to the innocent Weis directors and regulatory authorities that Weis' books had been examined under Rule 17a-5 and passed with flying

colors. As a result of these false assurances, Weis—and ultimately the public—has lost millions of dollars in this forced liquidation.

It is no answer to say that administrative remedies will suffice to prevent such *debacles*. Those remedies cannot be depended upon unless the accountants provide warning of the problems. When accountants fail to conform to Rule 17a-5 but nevertheless certify that no problems exist, they must be held accountable for the harm to the broker that ensues.

D. *There Is Pendent Jurisdiction Over the Trustee's Five Non-Federal Claims Since Those Claims Involve the Same Facts, and Should be Tried at the Same Time, as the Parties' Federal Claims.*

Since both plaintiffs state substantial federal claims under the Exchange Act as to which federal court jurisdiction is exclusive, the District Court clearly had and should have exercised pendent jurisdiction over the Trustee's five closely related claims based on State law. *United Mine Workers* v. *Gibbs*, 383 U.S. 715 (1966); *Almenares* v. *Wyman*, 453 F.2d 1075, 1083 (2d Cir. 1971), *cert. denied*, 405 U.S. 944 (1972); *Leather's Best, Inc.* v. *S.S. Mormaclynx*, 451 F.2d 800, 809-11 (2d Cir. 1971); *Astor-Honor, Inc.* v. *Grosset & Dunlap, Inc.*, 4[illegible] F.2d 627 (2d Cir. 1971); *Beverly Hills Nat'l Bank & Trust Co.* v. *Compania de Navegacione Almirante S.A., Panama*, 437 F.2d 301, 305-6 (9th Cir.), *cert. denied*, 402 U.S. 996 (1971).[7]

There is in this case much more than the "common nucleus of operative fact" which ordinarily justifies the ex-

[7] Even if only one of the plaintiffs stated a federal claim under Section 17, it would be proper for the Court to exercise pendent jurisdiction over the state-law claims of the other party arising from the same nucleus of operative fact. *Almenares* v. *Wyman*, *supra*.

ercise of pendent jurisdiction under the *Gibbs* case, *supra*. The same facts are likely to be relevant to all of the Trustee's and SIPC's claims, and the claims are such that the parties "would ordinarily be expected to try them all in one judicial proceeding * * *." *United Mine Workers* v. *Gibbs, supra*, 383 U.S. at 725.

The considerations relevant to the exercise of pendent jurisdiction are "judicial economy, convenience and fairness to litigants." *United Mine Workers* v. *Gibbs, supra*, 383 U.S. at 726. Those considerations ordinarily dictate that closely related claims all be tried in the same court. Here, the only place where all the Trustee's and SIPC's claims against Touche Ross can be tried is the District Court.

II.

As a Court of Bankruptcy and Chapter X Court, the District Court Had Independent Jurisdiction of All the Trustee's Non-Federal Claims.

Quite apart from its federal question and pendent jurisdiction over the Trustee's claims, the District Court had jurisdiction of the Trustee's five non-Section 17 claims by virtue of Sections 5 and 6 of SIPA (15 U.S.C. §§ 78eee and 78fff) and Sections 2a(7), 102 and 115 of the Bankruptcy Act (11 U.S.C. §§ 11(a)(7), 502 and 515), as made applicable by SIPA.

In his opinion below Judge Wyatt totally ignored the effect of these jurisdictional provisions, rejecting virtually without discussion their application to the Trustee's portions of the Complaint. (428 F. Supp. at 492.) Relying solely on Section 6(c)(1) of SIPA, the District Court ruled that its jurisdiction was limited by Section 23 of the Bank-

ruptcy Act to that of a court supervising Bankruptcy proceedings under Chapters I-VII of the Bankruptcy Act.[8] This ruling was erroneous for two reasons.

First, Section 6(c)(1) of SIPA is not a jurisdictional provision. It deals with the conduct of proceedings in the district court and before the Bankruptcy Judge. Other, jurisdictional provisions clearly confer upon Trustees and federal courts in SIPA liquidations the powers and jurisdiction of both bankruptcy courts and Chapter X courts; those provisions amply support the exercise of jurisdiction over the Trustee's claims in this case. Second, even assuming that Section 6(c)(1) of SIPA is to be read as a jurisdictional provision, that Section specifically incorporates all of the provisions of Chapter X not inconsistent with SIPA, including Section 115—a provision which confers on district courts the "home court" or ancillary jurisdiction of a federal equity receivership court over a plenary action brought by a trustee in the court of his appointment. The ancillary jurisdiction is also sufficient to support the Trustee's claims in this case.

A. *The Jurisdictional Provisions of SIPA Confer Upon District Courts the Same Jurisdiction of the Trustee's Claims as a Chapter X Court.*

While there is little, if no, discussion of the point below, it appears to have been Judge Wyatt's view that the issue of jurisdiction was controlled solely by reference to Section 6(c)(1) of SIPA; and that as a result of a hermetic construction of that provision the jurisdiction of the federal courts in SIPA liquidations was limited to that con-

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[8] Even as a court of such limited jurisdiction, the District Court had subject matter jurisdiction because of defendant's consent by filing two claims in the liquidation of Weis in this district—a point discussed at pp. 36-42, *infra*.

ferred by Section 23 of the Bankruptcy Act.[9] That provision, which applies in a Chapters I-VII bankruptcy, limits the district court's jurisdiction over an action between a trustee and an adverse party (other than actions involving preferential or fraudulent transfers) to that which would have existed in an action between the bankrupt and the adverse party before the bankruptcy. In Chapter X, on the other hand, the district court has unlimited subject matter jurisdiction under Section 2a(7) of the Bankruptcy Act over all suits by the Trustee. *Williams* v. *Austrian*, 331 U.S. 642 (1947).

Judge Wyatt's restrictive view ignores completely the additive pattern of all the jurisdictional provisions of SIPA. A review of all the jurisdictional provisions of the Act indicates that Congress gave SIPA trustees and SIPA courts the powers, functions and jurisdiction of both bankruptcy courts *and* Chapter X courts.

Thus, in Section 5(b)(2) of SIPA (15 U.S.C. § 78eee(b)(2)), Congress provided that the court in which a SIPA proceeding is initiated shall have the "powers * * * of a court of bankruptcy *and* of a court in a proceeding under Chapter X of the Bankruptcy Act." (Emphasis added.) This grant of "power" to a federal court is a jurisdictional grant. *United Mine Workers* v. *Gibbs*, 383 U.S. 715, 725 (1966); *Kendall* v. *United States ex rel. Stokes*, 37 U.S. (12 Pet.) 524, 622-23 (1838); *United States ex rel. Rudick* v. *Laird*, 412 F.2d 16, 20 (2d Cir.), *cert. denied*, 396 U.S. 918 (1969). Article III of the Constitution itself uses the word "Power" in this sense.

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[9] Section 23 is not referred to anywhere in SIPA, but Section 6(c)(1) does refer to sections referred to in Section 102 of the Bankruptcy Act. Section 23 is one such section. Section 6(c)(1), however, incorporates Bankruptcy Act provisions only to the extent not inconsistent with other provisions of SIPA.

Similarly, in Section 6(b)(1) Congress provided that a SIPA Trustee "shall be vested with the same powers and title with respect to the debtor and the property of the debtor as a Trustee in bankruptcy *and* a Trustee under Chapter X of the Bankruptcy Act * * *." (Emphasis added.) Even in SIPA Section 6(c)(1), the one part of the statute cited by Judge Wyatt, Congress provided that "[e]xcept as inconsistent with the provisions of this Act" a SIPA proceeding "shall be conducted in accordance with, and as though it were being conducted under" *both* the provisions of Chapters I to VII referred to in Section 102 of the Bankruptcy Act *and* "the provisions of Chapter X."

Nowhere in SIPA did Congress specifically limit the jurisdiction of the federal courts in SIPA liquidations to that of courts in bankruptcy as opposed to Chapter X courts. The concern in Section 6(c)(1) appears to have been with the conduct of the liquidation proceedings themselves, not with the jurisdiction of the district court.[10] If Congress intended to make all suits by a trustee subject to the straight bankruptcy jurisdiction provided for in Chapters I-VII it could have done so much more clearly and emphatically than by indirectly and perhaps unconsciously referring, in a section of SIPA dealing with conduct of proceedings, to a section of Chapter X which happens to refer to Section 23 along with several other sections of the Bankruptcy Act.

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[10] Thus, the circuitous reference to Section 23 by way of Section 102, if intentional at all, might be intended to ensure that the summary jurisdiction of the Bankruptcy Judge in SIPA liquidations will be precisely the same as in bankruptcy liquidations. Such an interpretation would mean that administrative claims processing and the like would be conducted "as though" the proceeding were a bankruptcy but not preclude access to the district court in complex cases such as this where considerations such as uniformity of practice and expertise in federal securities law would be desirable. The other provisions referred to in Section 102 deal with administrative matters.

Instead of expressly restricting the jurisdiction of the district courts in SIPA, Congress expressly did just the opposite. Throughout SIPA Congress gave SIPA courts and Trustees the powers and jurisdiction of courts and trustees under the provisions both of Chapters I through VII *and* of Chapter X. That grant included the "power" to entertain the claims alleged by the Trustee in his Complaint in this case.

B. *The District Court Had the Same Jurisdiction of the Trustee's Claims as a Federal Court Supervising an Equity Receivership.*

In addition to the jurisdiction over the Trustee's claims supplied by the key jurisdictional provisions contained in Sections 5 and 6 of SIPA, Section 6(c)(1) itself provides an ample basis for jurisdiction over these claims. By its actual wording that section conforms to the additive pattern of jurisdictional provisions in SIPA, and provides that federal courts in SIPA liquidations shall have at least the same jurisdiction as a federal court supervising an equity receivership under the jurisdictional grant of Section 115 of the Bankruptcy Act.

In Section 6(c)(1), Congress indicated that SIPA *first* incorporates all of the provisions of Chapter X of the Bankruptcy Act not inconsistent with SIPA, and *only then* supplements those already incorporated provisions with consistent provisions of Chapters I through VII of the Bankruptcy Act referred to in Section 102. Section 6(c)(1) states in pertinent part as follows:

> "*Except as inconsistent with the provisions of this chapter* and except that in no event shall a plan of reorganization be formulated, *a liquidation proceeding shall be conducted in accordance with, and as though it were being conducted under, the provisions of Chapter X* and such of the provisions * * * of Chapters I to

> VII, inclusive, of the Bankruptcy Act as section 502 of Title 11 [Section 102 of the Bankruptcy Act] would make applicable if an order of the court had been entered directing that bankruptcy be proceeded with pursuant to the provisions of such chapters I to VII inclusive * * *." (Emphasis added.)

Thus, the provisions of Chapter X are included in SIPA under Section 6(c)(1) even before one reaches the reference to Section 102 of the Bankruptcy Act and its indirect reference to Section 23. Such a provision of Chapters I through VII can be deemed included in SIPA only where it would be more consistent with the purposes of a SIPA liquidation than the previously incorporated provisions of Chapter X.

By incorporating the provisions of Chapter X, Congress incorporated the jurisdictional Section 115 (11 U.S.C. § 515) which gives the federal court of the trustee's appointment all the ancillary jurisdiction of the "home court" in federal equity receiverships. Hence Section 115 is incorporated into SIPA by Section 6(c)(1) before one even reaches the reference to Section 102 of the Bankruptcy Act. To extrapolate from the subsequent reference to Section 102 of the Bankruptcy Act (and its reference to Section 23) any limitation on the home court's equity receivership jurisdiction would thus be totally inconsistent with this already included provision of Chapter X. Particularly in view of Section 23's inconsistency with the key jurisdictional provisions of SIPA, the wording of Section 6(c)(1) of SIPA requires that the indirect reference to Section 23 in SIPA be accommodated to the previous inclusion of Section 115.

Section 115 of the Bankruptcy Act provides as follows:

> "Upon the approval of a petition, the court shall have and may, *in addition to the jurisdiction, powers,*

> *and duties hereinabove and elsewhere in this chapter conferred and imposed upon it*, exercise all the powers not inconsistent with the provisions of this chapter, which a court of the United States would have if it had appointed a receiver in equity of the property of the debtor on the ground of insolvency or inability to meet its debts as they mature." (Emphasis added.)

That this provision is an explicit jurisdictional grant within Chapter X is clear under the case law. *Williams* v. *Austrian*, 331 U.S. 642, 659-60 n.45 (1947) ("§ 115 has been interpreted as jurisdictional."); *In re Federal Facilities Realty Trust*, 220 F.2d 495, 499 (7th Cir. 1955) ("by express provision, the jurisdiction in reorganization includes all that a court of the United States would have had, if it had appointed a receiver in equity. Title 11 U.S.C.A. § 515"); *In re Cuyahoga Finance Co.*, 136 F.2d 18, 20 (6th Cir. 1943) ("The [1938] statute expanded the former [Bankruptcy] Act to give the court in reorganization proceedings such jurisdiction as a court of the United States would have if it had appointed a receiver in equity * * *. 11 U.S.C.A. § 515, 52 Stat. 884."); *Warder* v. *Brady*, 115 F.2d 89, 94 (4th Cir. 1940) ("The possession of this [equity receivership] jurisdiction by the bankruptcy court in a reorganization proceeding is confirmed by the provisions of Ch. X § 115, 11 U.S.C.A. § 515 * * *.")

One of the most important "powers" which a court of the United States would have if it had appointed such a receiver in equity would be the power to adjudicate any action instituted by its receiver (in this case the Trustee) regardless of the existence of independent jurisdictional grounds. As the United States Supreme Court explained in *Riehle* v. *Margolies*, 279 U.S. 218, 223 (1929):

> "The appointment of a receiver of a debtor's property by a federal court confers upon it, regardless of

> citizenship and of the amount in controversy, federal jurisdiction to decide all questions incident to the preservation, collection and distribution of the assets. It may do this either in the original suit, *Rouse* v. *Letcher*, 156 U.S. 47, 49-50, or by ancillary proceedings, *White* v. *Ewing*, 159 U.S. 36."

This power is sufficient to support the Trustee's non-federal claims in this case.

The continuing application and validity of this "home court" rule was confirmed in a recent national bank liquidation case decided by this Court. *United States* v. *Franklin National Bank*, 512 F.2d 245 (2d Cir. 1975). In the *Franklin Bank* case, the Court, while rejecting a court-appointed receiver's right to bring a suit in a district where he had not been appointed, explained that:

> "Had [the receiver] been able to maintain this action in the Southern District where he had been appointed receiver, however, no independent jurisdictional ground would have been needed for 'such action or suit is regarded as ancillary so far as the jurisdiction * * * is concerned; and we have repeatedly held that jurisdiction of these subordinate actions or suits is to be attributed to the jurisdiction on which the main suit rested. * * *' Pope v. Louisville, N.A.&C. Ry., 173 U.S. 573, 577, 19 S.Ct. 500, 501, 43 L.Ed. 814 (1899). * * * This rule is well settled, and the reasons for it are clear." (*Id.* at 249; citations omitted.)

Accord, e.g., Esbitt v. *Dutch-American Mercantile Corp.*, 335 F.2d 141, 142-43 (2d Cir. 1964); *Tcherepnin* v. *Franz*, 485 F.2d 1251, 1255-56 (7th Cir. 1973), *cert. denied*, 415 U.S. 918 (1974); 7 *Moore's Federal Practice* ¶ 66.07[3] at 1938-39 (2d ed. 1975).

Since Section 115 is a jurisdictional provision the only interpretation that is consistent with the actual wording of Section 6(c)(1), and with the provisions of Sections 5 and 6 of SIPA relating to the court's "power," is that Congress referred to Section 102 to make it clear that Section 23 would play some role in SIPA liquidations, but not that it would completely override Section 2a(7) and the equity receivership jurisdiction established by Section 115.[11] Obviously if Congress had simply been attempting to provide that district court jurisdiction under SIPA should be the same in all respects as in straight bankruptcies, it would have said so clearly and unequivocally, not by obscure references and indirection. Nowhere in SIPA, including Section 6(c)(1), did Congress choose so to limit the Chapter X "powers" of the district court given exclusive jurisdiction of a SIPA liquidation.

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[11] A SIPA trustee, for example, might not be able to rely on Section 115 to bring a plenary action in a federal district court other than his "home court" without having other independent jurisdictional grounds. To this extent, consistent with some aspects of the nature of SIPA proceedings, the trustee would have the same options as the receiver in a national bank liquidation. *See, e.g., United States* v. *Franklin National Bank, supra*, 512 F.2d 245, 249 (2d Cir. 1975).

The reference to Section 23 by way of Section 102 might also imply a limitation on the summary jurisdiction of the Bankruptcy Judge but not on the plenary jurisdiction of the district court supervising the liquidation. *See* note 10 at p. 30, *supra*.

III.

Touche Ross Consented to Jurisdiction by Filing Two Proofs of Claim for Services Which Are Related to Those Upon Which the Trustee's Claims Are Based.

Even under Section 23 of the Bankruptcy Act, 11 U.S.C. § 46, which the District Court erroneously viewed as applicable to the Trustee's Complaint, jurisdiction in the District Court exists by reason of Touche Ross' consent. This consent derives from two proofs of claim filed by Touche Ross against the Weis estate on July 10, 1973—a regular proof of claim for $75,443, and an apparent priority claim seeking $11,664 for services allegedly rendered for the benefit of the Weis estate. (293a-96a.) Both of these claims are connected with, logically related to, and involve some of the same documents and evidence as, the Trustee's causes of action for breach of contract, negligence and breach of warranty. They are therefore more than sufficient to imply consent by Touche Ross to the jurisdiction of the District Court as a Court of Bankruptcy. *E.g., Nortex Trading Corp.* v. *Newfield*, 311 F.2d 163 (2d Cir. 1962); *In re Farrell Publishing Corp.*, 130 F. Supp. 449 (S.D.N.Y. 1955); *cf. United Artists Corp.* v. *Masterpiece Productions, Inc.*, 221 F.2d 213 (2d Cir. 1955).

Judge Wyatt recognized the principle of consent to the jurisdiction of a Court of Bankruptcy but ignored one of Touche Ross' claims and misconstrued the impact of the other:

> "[T]he claim filed by Touche in the Weis liquidation was for accounting work in *European offices of Weis* in late 1972 and early 1973, as well as for a Stock Exchange audit as of April 27, 1973. The claim by the Trustee against Touche does not arise out of any work

> done for Weis by Touche and for which Touche filed a claim in the Weis liquidation. The claims are not 'mutual' therefore but are unrelated and the consent of Touche cannot be found. * * * " (Citation omitted; emphasis in original.) (428 F.Supp. at 492.)

In fact, the claim for work done in Weis' European offices comprises but a small fraction of Touche Ross' *general creditor claim*, and the court below erred in dismissing the relationship between this regular proof of claim and the claims asserted by the Trustee in the Complaint in this action. Moreover, the court below failed completely to consider Touche Ross' *priority claim*—a claim seeking compensation for evaluating false or fraudulent entries for which the Complaint in this action alleges Touche Ross is responsible.

Section 23b of the Bankruptcy Act expressly provides for the granting of jurisdiction by consent as follows:

> "Suits by the receiver and the trustee shall be brought or prosecuted only in the courts where the bankrupt might have brought or prosecuted them if proceedings under this title had not been instituted, *unless by consent of the defendant* * * *." (Emphasis added.)

See Schumacher v. *Beeler*, 293 U.S. 367 (1934).

The law is clear in this Circuit that, by filing a proof of claim in the Bankruptcy Court, a party consents to the Court's jurisdiction and voluntarily submits to the federal court not only in regard to securing his own relief, but in regard to any related counterclaims that the Trustee might reasonably raise against him in the same proceeding pursuant to his duty to collect the estate. In essence, the standard is a diluted version of the compulsory counterclaim standard. *Chase National Bank* v. *Lyford*, 147 F.2d 273,

277 (2d Cir. 1945); *In re Seatrade Corp.*, 297 F. Supp. 577, 579-81 (S.D.N.Y.), *appeal dismissed*, 418 F.2d 9 (2d Cir. 1969); *In re Ira Haupt & Co.*, 289 F. Supp. 966, 970-71 (S.D.N.Y. 1968).[12]

As stated by Judge Kaufman in *Nortex Trading Corp. v. Newfield*, 311 F.2d 163, 164 (2d Cir. 1962):

> "The filing by Nortex of its proof of claim is analogous to the commencement of an action within the bankruptcy proceeding. * * * It has often been recognized that counterclaims by the trustee against a claimant are within the summary jurisdiction of the bankruptcy court. * * * The claimant is deemed to consent to the jurisdiction of the court upon filing its proof of claim." (Citations omitted.)

Consent to jurisdiction is therefore implied where there is a logical relationship between the transactions or occurrences involved in the respective claims or where the proof will be overlapping. *E.g., In re Farrell Publishing Corp.,*

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[12] The rationale for the rule was explained by the Supreme Court in the leading case of *Alexander v. Hillman*, 296 U.S. 222, 241-43 (1935) as follows:

> *"By presenting their claims respondents subjected themselves to all the consequences that attach to an appearance * * * *"*
>
> * * *
>
> "Respondents' contention means that, while invoking the court's jurisdiction to establish their right to participate in the distribution, they may deny its power to require them to account for what they misappropriated. In behalf of creditors and stockholders, the receivers reasonably may insist that, before taking aught, respondents may by the receivership court be required to make restitution. That requirement is in harmony with the rule generally followed by courts of equity that having jurisdiction of the parties to controversies brought before them, they will decide all matters in dispute and decree complete relief. ** * * Distribution may not be made without decision upon the counterclaims. Nothing is more clearly a part of the subject matter of the main suit than recovery of all that to the res belongs. * * *.*" (citations omitted; emphasis added.)

130 F. Supp. 449 (S.D.N.Y. 1955) ("In effect the [Bankruptcy] Act declares a statutory policy to settle all related claims."); *In re Seatrade Corp., supra; In re Ira Haupt & Co., supra. See generally Moore* v. *New York Cotton Exchange,* 270 U.S. 593, 609-10 (1926); *United States* v. *Heyward-Robinson Co.,* 430 F.2d 1077 (2d Cir. 1970), *cert. denied,* 400 U.S. 1021 (1971); *United Artists Corp.* v. *Masterpiece Productions, Inc.,* 221 F.2d 213, 216 (2d Cir. 1955).

Consent to the juridiction of a Court of Bankruptcy is not limited to the summary jurisdiction of the Bankruptcy Judge. As this Court explained in *Chase National Bank* v. *Lyford,* 147 F.2d 273, 277 (2d Cir. 1945), the distinction between summary and plenary proceedings "relates not to 'jurisdiction' but to venue * * *."

In *Whitney* v. *Wenman,* 198 U.S. 539, 553 (1905), the Supreme Court stated:

> "Nor can we perceive that it makes any difference that the jurisdiction is not sought to be asserted in a summary proceeding, but resort is had to an action in the nature of a plenary suit, wherein the parties can be fully heard after the due course of equitable procedure."

This same idea was expressed in 1 *Moore's Federal Practice* ¶ 0.62 [3] at 678 (2d ed. 1977):

> "If the bankruptcy court could exercise summary jurisdiction but a plenary action is, nevertheless, brought by the representative of the estate, the defendant cannot complain because he has not been proceeded against summarily; and the plenary action may be brought in a federal court. This does not enlarge federal jurisdiction, for by hypothesis the matter could have been summarily litigated in a federal forum, *i.e.,* the bankruptcy court."

The Trustee, in short, was free to proceed in either forum, and it is scarcely unjust that he chose the forum better equipped to handle this complex case, and more likely to offer a full panoply of procedural safeguards to both parties.[13]

1. *The General Estate Claim.*

That consent to the Trustee's Southern District action exists in the present case clearly appears from the face of Touche Ross' two proofs of claim. Touche Ross' regular proof of claim asks for $75,443, of which $67,972 is sought for:

> "[S]ervices rendered covering the regular New York Stock Exchange, Inc. audit as of April 27, 1973 for the purpose of examining the Answers to Financial Questionnaire and Statement of Financial Condition as of that date." (294a)

This claim is based upon the same auditing practices, and preparation of the same kinds of reports, as were involved in the 1972 audit. Under standard accounting practices the audit as of 1973 would commence right where the 1972 audit left off—with the conclusions and certifications of the prior year. Thus, much of the evidence which the Trustee would need to evaluate Touche Ross' claim would be relevant to, if not identical with, the evidence necessary to support the Trustee's causes of action, especially his cause of action for breach of contract. *See Goldberg* v. *Touche Ross & Co.*, [1976-1977 Transfer Binder] Sec. L. Rep. (CCH) ¶ 95,759 (S.D.N.Y. November 9, 1976).

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[13] Indeed, the Trustee might well have been subject to criticism for not proceeding in the District Court in the first instance. *See In re Herz Importing Corp.*, 349 F. Supp. 1106, 1112 (S.D.N.Y. 1972); *In re Ira Haupt & Co.*, 289 F. Supp. 966, 972 (S.D.N.Y. 1968); *In re Wonderbowl, Inc.*, 456 F.2d 954, 956 (9th Cir. 1972).

Moreover, these post-July 1972 services were part of the ongoing accounting role which Touche Ross performed for Weis over the course of five years. In performing such services Touche Ross was under a continuing duty to Weis and its customers to use the information learned in one of a series of audits to correct prior, misleading certifications in previous audits in the same series. *Fischer* v. *Kletz,* 266 F. Supp. 181 (S.D.N.Y. 1967); *T. O. Bancroft* v. *Indemnity Insurance Co.,* 203 F. Supp. 49 (W. D. La.), *aff'd,* 309 F.2d 959 (5th Cir. 1962). *See Wilkin* v. *Dana R. Pickup & Co.,* 74 Misc. 2d 1025, 347 N.Y.S.2d 122 (Sup. Ct. Allegany Co. 1973).

Contrary to Judge Wyatt's superficial analysis, therefore, the regular proof of claim does not relate predominately to work done overseas; nor does it involve services which are unrelated or even severable from those performed by Touche Ross for Weis in 1972. The services upon which the regular proof of claim is based were an integral part of the ongoing accounting role which Touche Ross had in relation to Weis. Touche Ross' claim regarding them is connected with, and therefore relates back to, the Trustee's claims for breach of contract, negligence and breach of warranty in the audit as of May 26, 1972. *See Wilkin* v. *Dana R. Pickup & Co., supra.*

2. *The Apparent Priority Claim.*

Touche Ross' consent to jurisdiction is unusually evident in this case because, in addition to its regular proof of claim, it also submitted an apparent priority claim for services allegedly rendered for the benefit of the Weis estate—a claim which Judge Wyatt overlooked completely when rendering his decision. (428 F. Supp. at 492.) This claim seeks payment of $11,664 "For Services Rendered for benefit of estate" for:

"Meetings and conferences with personnel of the New York Stock Exchange, Inc. and the Securities and Exchange Commission;

"Substantiation and documentation of alleged fraudulent bookkeeping practices and entries;

"Confirmation of bank loans and related collateral as of April 13, 1973 applicable to the alleged fraudulent bookkeeping entries." (296a.)

Not only were these services part of the ongoing accounting duties which Touche Ross had with respect to Weis, but at least in this proof of claim, if not in the regular proof of claim, Touche Ross has asked directly for compensation for work done in large part to unravel some of the very same fraudulent bookkeeping entries which the Trustee alleges Touche Ross missed or allowed to be perpetrated in the first place. Thus, these services relate to, and indeed arise out of, the very transactions on which the Trustee's Complaint in this action is based.

The same evidence relevant to Touche Ross' claim for priority compensation is relevant to this action. It would be logical, in evaluating that claim, for the Trustee to reach the conclusion that prior services had been negligently performed or over-valued and counterclaim accordingly, especially when the claim itself seeks an apparent priority over general creditors. Although some of the Trustee's counterclaims here are of great magnitude, that type of counterclaim is essentially all that is involved in this litigation.

CONCLUSION

For the foregoing reasons, the Trustee's Complaint should not have been dismissed for lack of subject matter jurisdiction. The order of the District Court should be reversed and the case remanded for further proceedings.

Dated: New York, New York
July 12, 1977

Respectfully submitted,

HUGHES HUBBARD & REED
Attorneys for Plaintiff-Appellant Edward S. Redington, as Trustee for the liquidation of the business of Weis Securities, Inc.
One Wall Street
New York, New York 10005
(212) WH 3-6500

Of Counsel:

JOHN S. ALLEE
JAMES B. KOBAK, JR.
JOHN W. SCHWARTZ
HAROLD L. KAPLAN

ADDENDUM

ADDENDUM OF STATUTES AND RULES

Securities Exchange Act of 1934

Sec. 17 (15 U.S.C. § 78q) as in effect prior to the Securities Acts Amendments of 1975, P.L. 94-29 (June 4, 1975)

> "(a) Every national securities exchange, every member thereof, every broker or dealer who transacts a business in securities through the medium of any such member, every registered securities association, and every broker or dealer registered pursuant to section 15 of this title, shall make, keep, and preserve for such periods, such accounts, correspondence, memoranda, papers, books, and other records, and make such reports, as the Commission by its rules and regulations may prescribe as necessary or appropriate in the public interest or for the protection of investors. Such accounts, correspondence, memoranda, papers, books, and other records shall be subject at any time or from time to time to such reasonable periodic, special, or other examinations by examiners or other representatives of the Commission as the Commission may deem necessary or appropriate in the public interest or for the protection of investors."

SEC Rules

Rule 17a-5 (17 C.F.R. §240.17a-5) as in effect prior to SEC revisions of 1975, 40 F.R. 59712-17 (Dec. 30, 1975).

> "(g) *Accountant's certificate*—(1) *Technical requirements.* The accountant's certificate shall be dated, shall be signed manually, and shall identify without detailed enumeration the items of the report covered by the certificate.

(2) *Representations as to audit.* The accountant's certificate (i) shall contain a reasonably comprehensive statement as to the scope of the audit made, including a statement as to whether the accounant reviewed the procedures followed for safeguarding the securities of customers, and including, if with respect to significant items in the report covered by the certificate any auditing procedures generally recognized as normal have been omitted, a specific designation of such procedures and of the reasons for their omission, (ii) shall state whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances; and (iii) shall state whether the audit made omitted any procedure deemed necessary by the accountant under the circumstances of the particular case.

(3) Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required by paragraph (h) of this section.

(h) *Accountant's certificate; options to be expressed.* The accountant's certificate shall state clearly the opinion of the accountant with respect to the financial statement covered by the certificate and the accounting principles and practices reflected therein.

(i) *Accountant's certificate; exceptions.* Any matters to which the accountant takes exception shall be clearly identified; the exception thereto shall be specifically and clearly stated; and, to the extent practicable, the effect of each such exception on the related item of the report shall be given."

Securities Investor Protection Act of 1970

Sec. 5(b)(2) (15 U.S.C. § 78eee(b)(2)).

"(2) EXCLUSIVE JURISDICTION OVER DEBTOR.—Upon the filing of an application pursuant to subsection (a)(2), the court to which application is made shall have exclusive jurisdiction of the debtor involved and its property wherever located with the powers, to the extent consistent with the purposes of this Act, of a court of bankruptcy and of a court in a proceeding under chapter X of the Bankruptcy Act."

Sec. 6(b)(1) (15 U.S.C. § 78fff(b)(1)).

(1) TRUSTEE POWERS.—A trustee appointed under section 5(b)(3) (hereinafter referred to as "trustee") shall be vested with the same powers and title with respect to the debtor and the property of the debtor, and the same rights to avoid preferences, as a trustee in bankruptcy and a trustee under chapter X of the Bankruptcy Act have with respect to a bankrupt and a chapter X debtor."

Sec. 6(c)(1) (15 U.S.C. § 78fff(c)(1)).

"(1) GENERAL PROVISIONS APPLICABLE.—Except as inconsistent with the provisions of this Act and except that in no event shall a plan of reorganization be formulated, a liquidation proceeding shall be conducted in accordance with, and as though it were being conducted under, the provisions of chapter X and such of the provisions (other than section 60e) of chapters I to VII, inclusive, of the Bankruptcy Act as section 102 of chapter X would make applicable if an order of the court had been entered directing that bankruptcy be proceeded with pursuant to the provisions of such chapters I to VII, inclusive * * *."

Bankruptcy Act

Sec. 2a(7) (11 U.S.C. § 11(a)(7)).

"a. The courts of the United States hereinbefore defined as courts of bankruptcy are hereby created courts of bankruptcy and are hereby invested, within their respective territorial limits as now established or as they may be hereafter changed, with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in proceedings under this Act, in vacation, in chambers, and during their respective terms, as they are now or may be hereafter held, to—

* * * (7) Cause the estates of bankrupts to be collected, reduced to money, and distributed, and determine controversies in relation thereto, except as herein otherwise provided * * *."

Sec. 23 (11 U.S.C. § 46).

"a. The United States district courts shall have jurisdiction of all controversies at law and in equity, as distinguished from proceedings under this Act, between receivers and trustees as such and adverse claimants, concerning the property acquired or claimed by the receivers or trustees, in the same manner and to the same extent as though such proceedings had not been instituted and such controversies had been between the bankrupts and such adverse claimants.

b. Suits by the receiver and the trustee shall be brought or prosecuted only in the courts where the bankrupt might have brought or prosecuted them if proceedings under this Act had not been instituted, unless by consent of the defendant, except as provided in sections 60, 67, and 70 of this Act."

Sec. 102 (11 U.S.C. § 502).

"The provisions of chapters I to VII, inclusive, of this Act shall, insofar as they are not inconsistent or in conflict with the provisions of this chapter, apply in proceedings under this chapter: *Provided, however,* That section 23, subdivisions h and n of section 57, section 64, and subdivision f of section 70, shall not apply in such proceedings unless an order shall be entered directing that bankruptcy be proceeded with pursuant to the provisions of chapters I to VII, inclusive."

Sec. 115 (11 U.S.C. § 515).

"Upon the approval of a petition, the court shall have and may, in addition to the jurisdiction, powers, and duties hereinabove and elsewhere in this chapter conferred and imposed upon it, exercise all the powers, not inconsistent with the provisions of this chapter, which a court of the United States would have if it had appointed a receiver in equity of the property of the debtor on the ground of insolvency or inability to meet its debts as they mature."